√

Internal Revenue Service
memorandum

TL-N-1905-90
CLRobertson, Jr.

date: JAN 10 1990

to: District Counsel, Los Angeles CC:LA
Attn: James Yan, Esq.

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Tax Litigation Advice - [redacted]
Docket No. [redacted], Correction of Prohibited Transaction

This refers to you memorandum dated December 1, 1989, requesting tax litigation advice on petitioner's plans to correct the prohibited transaction in this case. You attached a letter from petitioner's counsel suggesting use of a simple interest method of calculating the total interest due on the loans to [redacted] which resulted in the prohibited transactions in this case.

After informally conferring with the Assistant Chief Counsel, Employee Benefits and Exempt Organizations, we have determined that either a simple or a compound method may be used to calculate the interest for correction purposes. However, the method selected must use a market interest rate that a bank would charge on a loan of equivalent terms, whether simple or compound interest is being calculated.

Either method should result in the same amount of interest to be paid. Typically, a commercial lender is more interested in the total profit than the calculation method and so would loan money at simple interest calculated at a higher market rate than the lender would loan at compounded interest. As suggested in our memorandum to you dated November 9, 1989, the key to correction here under the principles of Treas. Reg. § 53.4941(e)-1(c)(4) is that the disqualified person must: (i) terminate use of the property, i.e., repay the principal of the money borrowed, (rescission); (ii) pay the qualified plan the excess of the fair market value of the money borrowed (interest, whether calculated at simple or compound rates) over whatever interest was paid (the amount by which the plan was shortchanged); and (iii) pay the excess of any amount of interest the disqualified person would have paid from the time the principal was repaid to the end of the terms of the loans over the fair market interest rate for those time periods, i.e., the benefit of the original bargain goes to the plan. Unless interest rates have fluctuated greatly, it is unlikely that both (ii) and (iii) would be due in a single case.

In this case the taxpayer must have repaid the principal amount of the loans. In addition, a supplemental payment to the plan is necessary to reflect the difference between the amount of interest that was paid and should have been paid while the loans were outstanding. If, in this case, the loan documents promised less than fair market value rather than more than fair market value, it would not be necessary to make a second supplemental payment for the period from principal repayment to the end of the loan document period.

Therefore, we advise that you obtain from petitioner's counsel proof of the "fair market" interest rate (simple or compound) for the periods in question for loans of these amounts to persons like the taxpayer. Further, when you are satisfied that you have the fair market rate, whether simple or compound, you will be in a position to determine whether opposing counsel's calculations will result in correction under Treas. Reg. § 53.4941(e)-1(c)(4). Once you have agreed upon the amounts which need to be repaid, written documentation of the payment, e.g., a cancelled check showing deposit of the same to the qualified plan's account, should be sufficient to permit you to proceed to prepare decision documents for this case.

Please call Calder Robertson or myself at FTS 566-3407 if you have any questions.

MARLENE GROSS

Sarah A. Hall

SARAH A. HALL
Employee Plans Litigation
Counsel
Tax Litigation Division